Audit's® NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

# Realty Trust Review

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GROUP REVIEW AND SELECTION ISSUE



## GROUP REVIEW: ARE THE PROPERTY TRUSTS NEAR A PEAK IN VALUE?

Two major tender offers -- one completed, one in the wings -- have riveted investor attention on the property (or equity) realty trusts. Their stocks have performed strongly of late, although the higher average price has limited percentage gains compared to lower-priced recovery situations.

This broad price rise means you must ask this vital question: Are these stocks now priced so richly that you should defer new purchases and even take some profits?

As owners of income producing properties, the property trusts suffered relatively little income and dividend erosion during the 1974-75 real estate recession. Thus they came out of that recession, deepest in three generations, generally unscathed, paying dividends for the most part, and with financing sources open for further expansion.

In the past year they have come increasingly under scrutiny by large U.S. and foreign investors as potential acquisition candidates. Alternatively, many are eyed as potential liquidation candidates, on the general assumption that market value of the underlying properties far exceeds the market value of the stocks.

Wide acceptance of this assumption has caused the price surges in many of the property trust stocks. And it's this broad price rise that makes us ask the vital question above.

Widely held assumptions are always suspect. To "assume" something without question "can make an ass of

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both u and me," goes the expression, so we start by questioning the underlying beliefs fueling the price rise, which we perceive as follows:

Belief One: Real estate is an ideal inflation hedge. Investors used to believe this about common stocks -- until the rampant inflation of 1974-5 proved that profits and stock prices can be devastated by runaway inflation. As inflation rates have accelerated, investors have adjusted since then by cutting in half the average price they are willing to pay for earnings. As a result the Dow-Jones Industrial blue chip stocks today sell at about 6.8 times the latest 12 months' earnings, as against a minimum multiple of 12 during most of the 1950s and 1960s.

In like fashion, real estate and realty trust stocks are a hedge against inflation only so far as they can pass on rising costs to tenants and maintain a widening profit spread (measured several ways) that remains competitive in inflationary times. Put another way, the constant-dollar return on investment must at very least stay level.

Over very long time periods, real estate has been able to hold its own against inflation, although there are very real variations depending upon property types, locations, nature of leases, etc. In England and Europe, for instance, most leases, mortgages and other elements of commercial property are indexed to inflation or subject to frequent renegotiation, so that the real property owner and mortgage lender are protected from erosion of purchasing power of final returns.

Continental investors thus are comfortable with real estate as an inflation hedge because they have seen it work over long time periods -- decades and even centuries. Over those spans, Europeans have had to modernize most center-city real estate many times to maintain its competitive vigor. So it's no wonder that many Europeans view American real estate as an ideal inflation protection, a renewable resource that's also cheap because today's U.S. property prices are low compared to other nations.

But the trap for us and other investors is that the U.S. real estate market doesn't offer anywhere near the European degree of inflation protection in two important aspects:

One, investors aren't yet fully protected against inflation. Many large buildings are still tied up on long-term net leases, often at very low rates compared to the current market, and for very long times without any renegotiation or other price adjustment. To cite just one example: First Union Real Estate net leases its largest building, 972,000-sf Union Commerce Bldg. in Cleveland, to Union Commerce Bank under a 30-year lease initially expiring in 1991 and carrying two 10-year renewal options. The initial rent of $1.67 million yearly was 6.55% of the building's initial cost to the trust in 1961. FUR gets 1% of the bank's income from other tenants, although this overage has not risen as rapidly as inflation. That lease is very typical of deals made in the early 1960s -- deals that today lock real estate investors into anemic returns.

Most leases written in the 1970s have tried to cope with inflation by shortening terms, giving investors meaningful overages or pass-through of costs, etc. Shopping center leases especially have tied rents to gross retail sales, affording perhaps the best protection of all today. But many older shopping centers are hobbled by less attractive leases written with anchor tenants in the 1960s and 1950s. These centers hedge against inflation only to the extent that new leases dilute the negative impact of the older ones. In short, U.S. real estate leasing -- especially for newer properties -- is on the way toward protecting investors against inflation in the European mode, but the transition is by no means complete for older properties.

<u>Two, there is a limited tradition of constant modernization to keep properties competitive</u>. Europeans have been forced to modernize old properties because slower growth has meant a slower pace of new building, and out of a sense to preserve the historic architecture and ambiance of cities such as Paris or London.

Americans have been too prone to tear down the old and build anew, believing that newer is better. This has impelled many owners to spend their net cash flow (i.e., net cash after payment on mortgage debt) and take a cavalier attitude toward property maintenance and modernization. Rent control laws have given owners in some areas even less incentive to modernize.

The net result is that many owners believe, fervently, that depreciation is not real, that no building depreciates, and that inflation will bail them out of any undermaintenance (or milking) mistakes.

But today's new or modernized structures have enormous power to draw new tenants with newer facilities and services, better energy use, and many other amenities. In other words, properties can be obsolete much quicker than is supposed generally. In short, the retailing, office and apartment markets are more fiercely competitive now than we've seen them for years, and new buildings have greater capacity to outmode older unmodernized buildings than for some time. All that means real estate owners -- and the property trusts -- are peculiarly vulnerable to depreciation and obsolescence.

So we modify Belief One to read:

REAL ESTATE CAN BE MANAGED TO PROVIDE AN EXCELLENT INFLATION HEDGE BUT WILL BE ACCEPTED FOR INVESTMENT ONLY AFTER CLOSE EXAMINATION OF SPECIFIC PROPERTIES AND PORTFOLIOS.

<u>Belief Two: Real estate market values always rise relative to historic costs, and thus even adjusted book values of real estate trusts and companies understate true value.</u>

Valuing real estate doesn't lend itself to easy generalizations -- and that's part of the problem. An appraiser will value property by three methods and then select the most reasonable (perhaps near the average) of the three values. The three main valuation methods are:

--Reproduction cost, or the cost of building a structure without regard to whether that specific building would be appropriate now.

--Comparable sales, or what willing buyers and sellers have paid for similar properties recently. The hitch is that there may be unreported intangibles in some complex realty deals.

--Income capitalization, or the value of the net cash generated by a property. This method is preferred by most appraisers and can be adapted by stock investors to value a stock by capitalizing the net cash flow or dividend of a trust.

Since building costs tend to rise at about 1¼ to 1½ times faster than general inflation, reproduction cost of properties tends to rise faster than overall inflation. This is why you hear the oft-stated remark that properties in REIT portfolios today are worth far more than their book value.

And since many transactions are completed by investors using the same reasoning, comparable sales tend to follow the same rising trend.

But capitalized income value tends to be passed over -- or rationalized -- by many property buyers because it tends to lag other measures during rapid bursts of inflation as rents cannot be raised as quickly as costs. Buyers may rationalize low cash returns by styling them as en-

try level or going-in yields, expecting they will be able to boost these returns rather quickly. Thus many buyers today say they cannot find properties to return more than 5% or 6% initial cash flow on cash investment. Sometimes the yield is even lower.

In essence then, WE ACCEPT THE GENERAL PREMISE OF BELIEF TWO and say reproduction values will rise as inflation continues, and this will push reported sales values up. Initial cash returns may erode even more. The key is whether buyers will continue to seek real estate.

We think the three main types of active real estate buyers today will continue to seek property. All are sophisticated as to location, property modernization, lease terms, inflation protection, and all the other ingredients of modern real estate ownership. Thus sellers can't expect the greater fool theory to bail them out of their mistakes or sins of omission. Here is how we size up the three buying groups:

1. Foreigners. We commented on this group last issue but the ideas are worth repeating for emphasis: "The megabuck (foreign) buyers so far have different perceptions about future inflation rates (higher than most Americans have accepted), property replacement costs (cheap), today's real estate prices (dirt cheap compared to Europe and other industrialized nations), and politics (America remains stable and relatively receptive to private capital)." We consult with many foreign investors and can report that some are obsessive about getting their money invested in the U.S. Their appetite should continue unabated regardless of recessionary and energy impact on the U.S. economy.

2. U.S. institutions. Pooled funds set up by life insurance companies, banks and others took in a record $400 million from pension and profit sharing plans last year. They then reinvest this money into properties. The pension plans are being pushed by Federal laws (the ERISA law) to diversify and real estate is becoming a favorite outlet. But the pooled real estate funds have only about $2 billion net assets -- or about 1% of all pension fund assets -- in real estate. That percentage is expected to rise to about 5% the next few years -- meaning an unprecedented influx of new money into property ownership.

3. Tax-conscious U.S. individuals. The 1978 Tax Reform Act left real estate alone as the last big tax shelter investment. The real estate investor can still leverage property with non-recourse mortgage debt and write off depreciation and other deductions on the full investment. In contrast, the deduction is limited to investment amounts "at risk" in nearly all other areas. This means big dollars will continue to seek tax sheltered real estate deals -- and Congress doesn't appear interested in changing the law soon.

As regular subscribers know, REALTY TRUST REVIEW adds back accumulated depreciation to net book value for property trusts as a way of estimating market value of properties. Book value is adjusted in this fashion only for trusts which say by their dividend payouts they do not believe their properties have depreciated. The book value adjustment essentially assumes the properties are worth their initial cost. We have no doubt that market value of individual properties will fall above or below this mechanical adjustment but recent bids for entire trust portfolios (see RTR, April 13) have clustered within 15% plus-or-minus from this adjusted book value. The notable exception is General Growth Props. where a pending $35/sh. offer is 3.3 times adjusted book value.

In analyzing property trusts for this issue, we focused upon the age of properties and the amount of improvements and additions capitalized since a property was acquired. Generally we favor portfolios with most properties less

than 10 years old; properties dating from the 1960s and earlier usually should have been improved substantially to remain competitive. To measure the magnitude of modernization, we calculated two improvement ratios:

--One ratio measures total amounts capitalized as improvements to depreciation accumulated since properties were bought; the ratio shows the historical level of improvements to depreciation over the years of ownership.

--The second ratio shows the percentage of improvements in the latest year to the depreciation charge for the year, and is a more current measure of modernization. But since major improvements may be made in spurts, the ratio may be misleading in any one year.

One trust, San Francisco RE, carefully deducts funds for remodeling and improvements from its reported net cash flow; Audit defines net cash flow for all others as: Net income plus depreciation less mortgage principal repayments. Comments and advisories on trusts:

Consolidated Capital Realty Investors holds 82% of its investments in 26 apartment complexes with 8,995 units which are 96% occupied. The Willow Creek Apartments in Houston is the largest single investment, accounting for 13% of the portfolio. Of ConCap's 33 properties, 28 were built or renovated within the last 10 years, and depreciation was 13% of gross investments. ConCap has reinvested 24% of accumulated depreciation in capital improvements; the figure for fiscal 1978 alone was up to 31%, reflecting $3.75 million spent in capital improvements in last two years. In its annual report ConCap estimated replacement cost of its holdings at $160 million, a 63% premium over historic cost of $98 million. However, with the shares (30½ bid, OTC) trading at 19% premium over adjusted book, the market has accounted fully for asset appreciation, and the shares seem to merit play only for income.

Continental Illinois Properties is now 90% owned by Bouverie Properties, Inc., as result of a tender at $30/sh. ended July 12. The tender price was 26% over our $23.75/sh. adjusted book value. The tender likely means shares (29-3/4, NYSE) will be delisted soon. Bouverie is affiliated with the pension plans of Britain's National Coal Board and bought for long-term investment. We are now reducing shares to No. 3-Average Ranking.

Denver Real Estate Inv. Assoc.'s holdings are concentrated in new properties; its Diamond Hill office building accounts for 23% of property investments. Stouffer's Denver Inn for 19%, and its Lakeside shopping center for 19% (a nearby office park accounts for an additional 9%). The three properties contributed 73% of total revenues in 1978, for a combined 11.4% gross return on investment. The bulk of Denver's properties were constructed in the last ten years. The Lakeside shopping center, constructed in 1956, underwent a $3 million renovation in 1976-77 to convert into an enclosed mall. The renovation largely accounted for Denver's reinvestment of 247.4% of gross depreciation in capital improvements; in 1978, the trust spent 153.5% of depreciation charges on improvements. Denver uses part of its depreciation charge to shelter sinking fund payments on its debentures from dividend payment requirements. While the trust does not have the appeal of broader-based trusts with higher yields, such as First Union and Federal Realty, the shares (18½ bid, OTC), warrant play for high quality properties and management expertise in its area. Management recently said it believed its properties had $30/sh. real estate value, assuming continued vigor in Denver real estate and willingness of a cash-heavy investor to accept low initial cash yields. Emergence of such an investor is uncertain and the shares at 13% over $16.41/sh. adjusted book are ranked No. 2 for above-average attractiveness.

Federal Realty Inv. invests mainly in shopping centers and apartment buildings largely located in the D.C. area. Its 13 shopping centers provided about 75% of cash flow and are virtually fully leased. While the shopping centers are mostly late 50's and early 60's vintage, Federal appears to be moving to upgrade them; 83.4% of depreciation charges were spent on capital improvements in 1978, as opposed to 32.9% of gross depreciation which has been rein-

vested over the years. Major renovations, including expansions, were planned for two shopping centers this year; trust is also purchasing seven additional shopping centers from Amterre during the second half. By year-end, the trust will have more than tripled its real estate investments over the last three years, and its free-and-clear return on property investments continues high (11.6% last year). The No. 1 Ranked shares (16-5/8, ASE) are yielding 8.2% and are a good play for income and growth through acquisitions at 25% over our adjusted book value of $13.34/sh.

First Union RE Investmts., the largest self-administered real estate equity trust in the country, invests mainly in large high-rise office buildings (94% occupied) and enclosed shopping malls (97%). The trust is continuously turning over its portfolio; all of its 12 malls were acquired within the last ten years and eight of them were acquired within the last five years. A major criterion for acquisition is that the mall must be suitable for expansion in order to strengthen market position. First Union also actively participates in mall merchandising and promotions. In addition, the trust is rapidly expanding its holdings of office buildings, and has invested 34% of accumulated depreciation in capital improvements. The shares (15, NYSE) are selling at an 11% discount from $16.80 adjusted gross book value and are currently yielding 8%. With new management aggressiveness, the No. 1 Ranked shares appear to have further upside potential.

Florida Gulf Realty Trust owns 14 shopping centers, all but one located in Florida, with 1.97 million net rentable square feet of space, accounting for 92% of invested assets. Eight small office buildings in Tallahassee account for remaining 8% of investments. About two-thirds of shopping center space was built in 1960 - 1961 and the remaining one-third dates from 1970-71. Improvements through the April 1978 fiscal year amount to only 6.8% of depreciation accumulated since FGRT acquired the centers in 1973; this ratio is among the lowest for property trusts surveyed. Improvements were 16% of depreciation charges in 1978, latest year available and the biggest improvement year to date. FGRT has experienced recurring rent losses from tenant bankruptcies: W.T. Grant had occupied 119,000 sf or 6.0% of space and 2.4% or 46,900 sf remains vacant at latest report; Food Fair, Inc. has disaffirmed leases for 86,200 sf or 4.4% of total space; and Neisner Bros., Inc. has disaffirmed leases for 82,900 sf or 4.2%, of which 9,600 sf has been re-rented at higher rates. Strong overage rents from other tenants overcame the drag of these failures in the April 1979 year and both gross rents and net cash flow rose to new records, NCF hitting $1.45/sh. The shares (14½ bid-OTC) sell 28% below our adjusted book value and so we retain the No. 1 Ranking for now, although the low improvement ratio & tenant difficulties temper enthusiasm.

General Growth Properties has received an offer of $35/sh. from Marathon Realty, unit of Canadian Pacific Investments, subject to investigation, shareholder vote expected in August or Sept., and other conditions. These are shares of a major shopping center developer and owner and a higher offer is possible, although none has materialized to date. We rank the shares No. 3-Average at 34-5/8 (NYSE) pending the formal offer.

Gould Inv. Trust holds over 50 properties, including office buildings, industrial buildings, shopping centers, restaurants, apartment complexes, and land parcels. The properties are generally not institutional quality, being low cost, low visibility properties, although Gould keeps them in good repair; 38.9% of gross depreciation has been spent on capital improvements, and a lower, but still respectable, 20.4% of depreciation was reinvested in fiscal 1978 alone. The properties generally produce a satisfactory income; although the trust has some problems with bankrupt tenants, it has always been successful in re-leasing vacant space. The shares (13-7/8, ASE), 35% owned by the Gould family, yield a respectable 6.3%, but the ownership, combined with a P-E

of 13 for basically dull properties, make an unwanted acquisition unlikely. We continue to rank shares No. 2 as being among the more fully priced, although the 24% discount from $18.23 adjusted book value points toward some further potential.

GREIT Realty is troubled by locations of two of its three major properties, an office building in Dayton (14% of assets) and a shopping center in Miami (28%). Mead Paper Co. vacated 65% of the space in the Dayton building in 1977, and while some of the space has been re-leased, considering the very soft market for office space in Dayton, it will be years before all the vacancies will be eliminated. The Miami shopping center, which was constructed in 1960, is being hurt by competitive pressures. The trust renovated the Miami shopping center in 1977 and its other large center (28% of assets), located in Hillside, Illinois, in 1976. While overall the trust has spent 38.9% of accumulated depreciation on capital improvements, the figure dropped to 14.6% for 1978. Historically, GREIT has not paid dividends out of depreciation but the April quarter net income of 9¢/sh. was below the dividend of 10¢/sh., which indicates possible use of depreciation to keep dividends up while properties drift. The shares, at 10 (ASE), are a speculative play for price at about unadjusted net book value, new management, Unicorp Financial Corp. (Toronto) ownership of 18.3% of shares, and longer-term recovery. However recent price runups seem to limit potentials and we are cutting shares back to a No. 2 Ranking. We do not adjust GREIT's book value upward because of the uncertain nature of its depreciation.

Hubbard Real Est. Inv. is in the position, now that all the former Grant stores have been re-leased, of finding suitable investments for its over $10 million in cash. The Grant problem pointed up the need for diversification in the company's portfolio of properties net leased to a few major companies; but the trust's unwillingness to pay the going price for prime property, which has been bid up as a result of foreign competition, combined with its conservative financial position (it has only $2.5 million mortgage debt), might make it a prime target for acquisition-minded foreigners. However, if the trust is worried about its Chrysler leases (17% of property), it would be unwilling to acquire more leverage at this point. Hubbard's properties are all high quality buildings which have been built within the last ten years and many of which have been expanded and improved. Other major lessees are Ashland Oil (17%) and Safeway (20%). The leases themselves, most of which fall in the 7% to 8% range, are not competitive at today's rates; full return hinges on the theory that the money is reinvested. The No. 2 Ranked shares (18-5/8, NYSE), warrant purchase for superior asset value, 8.8% current yield and possible acquisition speculation. Because most holdings are accounted for as financing leases, we do not adjust book value.

New Plan Realty Trust specializes in aggressively managing older properties, mainly shopping centers, so they provide superior net cash flow. Shopping centers account for 80% of invested assets and slightly over 80% of net cash flow; remaining properties are apartments and industrial-commercial. The 592,000 sf Roosevelt Mall complex and adjacent John Wanamaker store in Philadelphia provide major cash flow. Substantially all leases now give inflation protection. The trust bought three centers last year, all well below replacement cost, and is now trying to upgrade return. Improvements amounted to 27.1% at July 1978. Rodney Plaza in Dover, Del., vacated by W.T. Grant, is only problem. Management puts market value of properties at about $16/sh. and our adjusted book value is $5.47. The shares (9-5/8, ASE) sell between the two values, reflecting superior return on gross investment. We continue their No. 2 Ranking for steady dividend and long-term benefits of aggressive management.

REIT of America, the oldest U.S. trust, invests in diverse properties. In recent periods, new leases at higher rents at the trust's two Calif. shopping centers (44% of portfolio) have far outweighed the absence of revenues from the razed Crowley Milner store in Detroit; results also have benefited from Proposition 13. Properties have been well kept up as 140.8% of accumulated depreciation has been reinvested in capital improvements; REITA also is beginning to expand its portfolio again,

making its first major purchases since 1974. The No. 2 ranked shares (20, ASE), selling at an 11% discount from net book value and yielding 8.0%, are attractive for income and long-term appreciation.

Virginia REIT invests mainly in shopping centers and apartment buildings; following a 1978 refinancing, the trust can consider portfolio expansion for the first time since 1975. While the trust's operating properties are 100% occupied, benefiting from the reinvestment of 50.0% of accumulated depreciation in capital improvements, results continue to be penalized by a high 17% non-earning assets, which are slowly being liquidated. The shares (12¼ bid, OTC), at a discount of 14% from adjusted book of $14.30 and yielding 6.5%, are No. 2-ranked for long-term gains after non-earning assets are eliminated.

We will review additional property trusts in the July 27 RTR.

REALTY TRUSTS IN THE NEWS: CONTROL CHANGE AT C.I. REALTY; SPEEDUP AT HANOVER SQUARE

A dissident shareholders' group has agreed to buy 20½% of C.I. Realty's stock from its adviser, C.I. Planning Corp. and boost to 49% their stake in the trust. The group, headed by David J. Greene & Co., New York City investment adviser, previously had announced plans to sponsor an opposing slate of trustees and to seek liquidation at the Aug. 30 annual meeting. Four trustees have resigned and others said they wouldn't seek reelection. The new group named Carl Glick, New York City financial consultant and widely known real estate analyst, as C.I. Realty's new president.

The dissidents agreed to pay $24½ for the 533,870 shares accumulated by C.I. Planning, subsidiary of City Investing Co., for $13.1 million total value. The Greene group brought in Great American Insurance Co.; a Studebaker-Worthington Co. pension plan; Hambros Bank Ltd.; and several individuals.

Sale ends several earlier aborted attempts to seek C.I. Realty control. About half the trust's assets are in two major Manhattan office towers that have benefitted by the sharp recovery in rents and occupancy in Manhattan. It also owns over 2,000 Midwestern apartments and a Kansas City shopping center.

Fidelco Growth Investors shareholders meanwhile defeated an attempt by Philadelphia insurance man Sidney Baer to nominate eight non-management candidates to Fidelco's board. The management slate was re-elected. Baer owns about 16% of Fidelco shares. Fidelco will sever its ties to bank holding company Fidelcor later this month and become internally administered. As part of the separation, Arno Krumbiegel has resigned as president of Latimer & Buck Advisers, the former adviser, and remains as trust president. David M. Boyce resigned as chairman of Latimer & Buck and is negotiating to become Fidelco chairman. Shares have moved up to 6 (ASE) but we retain our No. 1N Ranking.

Hanover Square Realty Inv. said it would dispose of its realty investments "in an orderly manner without regard to time constraints," using proceeds to reay bank debt. The move accelerates a plan announced earlier to build trust liquidity. Wall Street speculation is that the trust may convert assets into cash fairly quickly and invest that cash at today's high money market rates, sheltering the income via its taxloss carryforwards. On that basis we can project about $13.50/sh. liquid assets in three years, or about a 16½% annual return on today's stock price (8-1/8, ASE). We're moving the No. 2N-Ranked shares to No. 1N.

Independence Mortgage Trust says it will seek shareholder approval of a plan to swap a major portion of its assets to creditor banks in exchange for substantially all trust debt. Following the exchange, Independence would hold three currently-owned assets, some cash and incidental assets and claims. The trust would issue 125,000 new common shares to banks.

A credit agreement with banks has been extended from June 1 to Sept. 1 to let the trust seek shareholder approval. To date no other trust has sought holder sanction of asset swaps.